

Testimony of  
John D. Echeverria  
Executive Director, Georgetown Environmental Law & Policy Institute  
Georgetown University Law Center

Hearing on H.R. 3355, the Homeowners Defense Act of 2007

Before  
the Subcommittee on Housing and Community Opportunity and  
and the Subcommittee on Capital Markets  
Committee on Financial Services

September 6, 2007

My name is John D. Echeverria and I am the Executive Director of the Georgetown Environmental Law & Policy Institute at Georgetown University Law Center. I appreciate the opportunity to testify today on H.R. 3355, the Homeowners Defense Act of 2007, and to address, more generally, the appropriate role of the federal government in supporting the availability of fairly priced coastal disaster insurance. The views I offer today are my own, and do not represent the position of Georgetown University, Georgetown University Law Center, or the board of the Georgetown Environmental Law & Policy Institute.

The Georgetown Environmental Law & Policy Institute recently published a report on this topic authored by Justin R. Pidot, a Fellow with the Institute during the 2006-2007 academic year. I understand that a copy of the report, *Coastal Disaster Insurance in the Era of Global Warming, The Case for Relying on the Private Market*, will be included in the hearing record. The report is also available at: <http://www.law.georgetown.edu/gelpi/CoastalDisasterInsuranceReport.pdf>.

At the outset, I should acknowledge that I am not an expert in insurance law nor in the operations of the insurance industry, the reinsurance business, or the broader capital markets. However, I have spent a great many years studying, in various contexts, the effects of different liability and incentive regimes on the behavior of governments and private entities. Also as reflected by our recent report, the Institute has devoted significant resources and energy over the last year to studying the implications of different potential government policies relating to coastal disaster insurance.

In approaching the issue of coastal disaster insurance, our analysis has been driven by two basic policy concerns: fairness and efficiency. In this context, the fairness concern is that citizens and communities should generally bear the costs associated with their decisions and that other citizens and communities should not be asked to subsidize these costs. The efficiency concern is that society as a whole will be better off if citizens and communities make decisions that take full account of the private and public costs of their choices. The fairness and efficiency concerns are related in the sense that, everything else being equal, avoiding unfair subsidies is likely to increase the ability of individuals and communities to make rational, fully-informed decisions that will enhance the general welfare. More specifically, in the context of coastal disaster insurance, we as a society are more likely to achieve the right level of risk avoidance and risk mitigation if citizens make decisions about what to develop and where to develop based on the actual costs associated with their choices.

We have concluded that, for several different reasons, a significant government intrusion in the market for coastal disaster insurance is not likely to serve the goals of fairness and efficiency. For understandable but nonetheless regrettable reasons, government, especially the federal government, can generally be expected to do a poor job of supporting coastal disaster insurance that is priced to reflect its true cost. The financial burdens imposed by disasters, and/or the premiums necessary to cover such losses, create a strong, concentrated, and highly motivated constituency seeking financial

relief from these burdens. On the other hand, the costs to the federal government and in turn to federal taxpayers of providing this relief are dispersed and often deferred to the future. As a result of this political dynamic, there is a substantial risk, verging on an inevitability, that federal government involvement in the disaster insurance market will lead to systematic under-pricing of coastal disaster insurance. Furthermore, the costs to the federal taxpayers of federal intervention in the disaster insurance market are likely to increase over time.

Under our federal system, responsibility for addressing coastal disaster hazards is generally divided between different levels of government. Traditionally, local governments, and to a lesser extent state governments, exercise primary regulatory authority over land development. On the other hand, disaster relief is generally regarded as a responsibility of the federal government; in line with this approach, H.R. 3355 would require the federal government to serve as a financial backstop for state insurance programs. If land use regulatory authority remains at the state and local levels but the federal government serves as a financial backstop, the level of government with the most to gain from development (through increased tax revenues, and general economic development) will bear relatively little financial exposure from potentially unwise development, whereas the level of government with the greatest financial exposure will have little direct authority to limit and mitigate the risks associated with unwise development. This misalignment of incentives will tend to encourage unwise coastal development, create greater long-term risks, and ultimately impose greater costs on federal taxpayers.

We can predict these outcomes with a fair degree of confidence based on the unfortunate history of the National Flood Insurance Program, under which the federal government already plays a major role in providing insurance coverage for flood damage associated with coastal disasters. This program, established in 1968, was originally designed to guarantee the availability of flood insurance while simultaneously promoting new controls to limit vulnerable development in flood-prone areas. Unfortunately, the program now provides a major subsidy, not only for pre-existing development but also for new development in floodplains, with the result that the program has actually become a major engine for unwise development in floodplains. In some cases property owners have received multiple payments because their properties flooded time and again, despite the fact that, in the absence of the federal program, no rational individual would rebuild and no rational private insurer would offer coverage in the floodplain. In addition, the majority of NFIP flood maps are out-of-date, with the result that many maps fail to identify properties that are within the 100-year flood plain and should be covered by insurance. Finally, as we discuss in our report, because the federal government bears the lion's share of the financial risks associated with unwise development, local governments sometimes act recklessly by encouraging floodplain development.

The concern that political pressures would lead the federal government to adopt policies leading to under-pricing of disaster insurance becomes even more serious when one considers the fact that environmental factors are likely to put significant upward pressure on insurance rates. The growing scientific consensus about global warming

suggests that sea levels will rise significantly over the next century, making more coastal areas vulnerable to storm damage. In addition, because of the commencement of a natural cycle of heavy hurricane intensity, and perhaps due to global warming, hurricanes apparently are becoming more intense. As coastal areas become more prone to storm damage, common sense suggests that, absent government interference, insurance rates would rise in order to cover the larger risks. Higher rates would also have the salutary effect of sending property owners and investors valuable price signals about the hazards they face. On the other hand, if insurance rates were constrained for political reasons, insurance rates both would become increasingly divorced from fair rates as determined by the character of the underlying risks and would not effectively inform owners and investors about the risks they face.

All of the likely negative consequences of federal government intervention in the insurance business, as serious as they appear to be, might be acceptable if a government backstop were the only alternative. But our review of the available evidence indicates, at a minimum, that the proponents of federal intervention have not made the case that private reinsurance and innovative capital instruments cannot serve this backstop function as well or better than the U.S. Treasury.

By way of background, it is noteworthy that a federal takeover of the flood insurance business was hardly the only possible option. In the early part of the last century, after a series of disastrous Mississippi River floods, Congress began to debate the need for federal flood insurance. On the theory that the risks involved were too unpredictable and/or beyond the capacity of private insurers to deal with, Congress eventually created the National Flood Insurance Program. But other nations have left the business of flood insurance largely if not entirely to private insurers. It is fair to ask whether our nation's overall vulnerability to flood risks would be lower today if Congress had never created the flood insurance program and left the business of flood insurance to private insurers.

Recent developments in the insurance industry suggest that the private sector can succeed in providing insurance to citizens and businesses in hazardous coastal areas at a fair price that reflects the true costs of the covered risks. While hurricanes and other coastal storms are not an every day event, the occurrence of coastal storms and the magnitude of the potential economic losses are reasonably predictable. There is now a small but rapidly growing business in generating detailed predictions about where storms will occur and with what impact, as described in Michael Lewis's article in the August 26, 2007, New York Times Sunday Magazine. These predictive data are in turn providing the information base necessary to support capital investments in insuring against coastal disasters. There is now reportedly a \$14 billion market in investments in disaster insurance and the market continues to grow.

So far as we have been able to determine through our research, there is no serious obstacle to reinsurers and private investors supplying the necessary backstop for a well functioning coastal disaster insurance business. Given the size of the worldwide capital markets, and the likely magnitude of future disasters, the capital market appears adequate

in size to absorb the inevitable year to year swings in the number of disasters. Over time, as the predictive data improve in quality, and investors gain experience in pricing these instruments, the prices of these instruments should stabilize at a level that fairly and accurately reflects the underlying risks. The participation of numerous investors in this market, each with a relatively small stake in the overall risk pool, should, again over time, reduce if not eliminate the premiums that investors apparently now demand based on the unpredictability of coastal disasters (the so-called “timing problem”).

Thus, the most serious obstacle to the eventual emergence of a private market solution to the current so-called insurance crisis appears to be potential federal legislation that would allow the federal government to effectively supplant the private sector and cause the private market in disaster insurance instruments to shrink and wither away.

In sum, the best federal government policy with regard to coastal disaster insurance appears to be a policy of doing as little as possible. On the one hand, there is a substantial danger that federal intervention would lead to unfair and inefficiently low insurance rates for coastal disasters. On the other hand, there is no apparent reason why, over time, the private insurance companies and investors cannot support a well-functioning insurance business in which insurance premiums reflect the true market price of the coverage. No doubt there are risks of dramatic swings in the private marketplace based on the emergence of new information and irrational market sentiments. But, on balance, the risk to the taxpayer and to the country’s general economic welfare appears significantly lower if, to the extent possible, the business of investment is left to insurance companies and to private investors.

This is not to suggest that there is no role for the federal government (and state governments) in the insurance market for coastal disaster insurance. As detailed in the recent Institute report, there appear to be at least several targeted reforms worth considering. First, the federal government could play a useful role in generating better maps and other data that would allow insurance companies and other private firms to do a better job of estimating the magnitude of the risks associated with different areas of the coast as well as with specific properties. These data would allow insurance companies to do a better job of fine tuning insurance rates to reflect the risks associated with individual properties and avoid generalized premium structures that ignore differences between properties. In addition, these data would be of assistance to Applied Insurance Research and similar companies that develop risk assessments of coastal hazards. While the NFIP has done a woefully poor job of keeping flood maps current, the existence of a growing private sector audience for coastal hazard information offers hope that the federal government might develop a stronger information dissemination capability in the future.

Second, Congress should consider amending the Internal Revenue Code to eliminate taxation of insurance premiums that companies devote to reserve funds to cover catastrophic losses. Under current law, private insurers pay ordinary taxes on any portion of the premium they set aside as a reserve against future losses, leaving companies with little incentive to set aside adequate funds to cover catastrophic losses. Allowing insurance companies to “bank” premiums to cover future catastrophes would allow

companies to treat disaster insurance like other, more predictable lines of coverage, and expand companies' capacity to offer hurricane insurance. If it were to pursue this option, Congress would need to take care to ensure that banked premiums are eventually used to pay disaster insurance claims and not simply accumulated as an untaxed corporate asset.

Third, Congress should consider providing targeted financial assistance to low and moderate income families that have been particularly hard hit by spikes in coastal insurance rates. This assistance should be limited to those who purchased their properties at least several years ago and who can fairly claim that they purchased their properties without full knowledge of the hazards involved. To avoid distorting the insurance market and creating so-called "moral hazard" problems, this relief should not be supplied in the form of lower insurance rates, but rather in the form of direct grants or, as recently suggested by one of the co-directors of the Wharton School's Risk Management and Decision Processes Center, through some type of voucher system.

At the state level, state governments should consider making wind insurance mandatory for all those in vulnerable areas of the coast. Automobile liability insurance is mandatory in most states, and Massachusetts now requires all residents to carry health insurance. Given the infrequency of coastal disasters, citizens tend to discount the nature of the risk they face and therefore tend to underinsure. Mandatory coastal disaster insurance would overcome this psychological effect, enhance every community's ability to deal with a disaster, and compel citizens to recognize and take into account the different level of hazard associated with building and owning property in different areas.

Finally, I offer the following brief comments on H.R. 3355, the Homeowners Defense Act of 2007. First, the bill does not appear to advance the goals of fairness and efficiency I outlined at the beginning of my testimony. Through the liquidity and catastrophic loan programs, the bill would make the federal government the financial backstop for states (with or without "qualified" state reinsurance programs) by requiring the Secretary of the Treasury to make loans to states at predetermined interest rates. There is no indication that these interest rates are intended to match the market price of providing insurance for the covered risks. In fact, the proposed rates appear significantly lower than those now being earned in the capital markets by cat-bonds. The bill also includes a broad provision for extending the term of any loan upon state request. The predictable effect of these provisions would be to extend an unfair taxpayer-funded subsidy to those who choose to live and work in hazardous coastal areas, encourage further development in hazard-prone areas, and stifle the development of a private market backstop for coastal disaster insurance.

One striking feature of the bill is the complete absence of any explicit requirement that local or state governments take specific steps to control and mitigate disaster risks as a condition for eligibility for the federal backstop. The effectiveness of such mandates is questionable, based on experience under the National Flood Insurance Program. Nonetheless, it would seem appropriate, at a minimum, to consider mandating risk mitigation and control in order to decrease, at least to some degree, the incentives these federal loan programs would otherwise provide for unwise coastal development.

The purpose and likely effect of creating the proposed consortium is unclear. As I have discussed, there is a role for the federal government in generating additional hazard data information and disseminating that information to private insurers and risk assessment firms, and the consortium might help serve that function. But it appears doubtful that states facing relatively low levels of risk would perceive any particular advantage in banding together with states facing higher risk levels in order to seek pooled investments to help cover coastal disaster risks. In addition, from the point of view of reinsurers and private investors, it appears questionable whether there would be any particular advantage in a quasi-federal entity attempting to pool risks in a way that the market might or might not find attractive. As we describe in our report, private insurers are already independently putting together packages of different types of risks in order to attract more outside investors. Finally, to the extent the existence of the consortium would create the misperception that the federal government is prepared to backstop state insurance programs, the mere creation of the consortium would likely skew insurance premiums and encourage unwise development.

\* \* \*

Thank you for the opportunity to testify and I would be happy to respond to any questions that members of the Committee may have.